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In the Supreme Court of the United States

OCTOBER TERM, 1949

No. 662

NICHOLAS W. MATHEY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 104-115) are reported at 10 T.C. 1099. The opinion of the Court of Appeals for the First Circuit (R. 135-142) is reported at 177 F. 2d 259.

JURISDICTION

The judgment of the Court of Appeals for the First Circuit was entered on October 19, 1949 (R. 142). The taxpayer's petition for rehearing was denied by the court in an order entered Decem-

ber 12, 1949 (R. 149). The petition for a writ of certiorari was filed on March 10, 1950. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether, in the circumstances of this case, the Tax Court was correct in holding that the net proceeds of a patent infringement award were taxable as ordinary income.

STATUTE AND REGULATIONS INVOLVED

These will be found in the Appendix, *infra,* pp. 12-15.

STATEMENT

The relevant facts on which both the Tax Court and the Court of Appeals were in agreement may be summarized as follows:

Taxpayer, a resident of Massachusetts, filed his individual income tax return in the tax year 1944 on a cash and calendar year basis. In 1931, while doing business as Hamlin Machine Company, he obtained a patent for a shoe machine. In that same year, he gave formal notice of infringement to United Shoe Machinery Corporation. In 1937, he brought suit for infringement against United, alleging in his complaint that but for the infringement he would have been "in receipt of large gains and profits", and that United had derived "great gains and profits" from its infringement. He asked that United be perpetually enjoined from further infringement, that it be ordered to pay

over both the profits that it made from its infringement and also the damages which the taxpayer had suffered therefrom, and that a master be appointed to take and state an account of the profits and to assess the damages. (R. 104-106.)

The District Court entered judgment for the taxpayer on three of the four patent claims pursuant to its memorandum opinion reported in 32 F. Supp. 684, affirmed, 117 F. 2d 331 (C. A. 1st), except as to an item of costs. On remand, the District Court entered a judgment on the mandate of the Court of Appeals awarding taxpayer the relief for which he had asked in his complaint, and appointed a master to take and state the amount of the damages taxpayer had sustained, and of the gains and profits which United had made by reason of its infringement of the three claims held valid. (R. 106.)

At the hearings before the master, taxpayer abandoned his claim for profits and pressed only his claim for damages which the master found amounted with interest to over $70,000. To this the master added interest on certain items of damages from a date prior to the liquidation of the damages because of "special circumstances." The special circumstances were that the defendant's infringement had been deliberate and premeditated and, for the purpose of destroying taxpayer as a competitor, United had pursued a pricing policy with respect to its infringing ma-

chines which it knew would be ruinous to taxpayer whose business was small and financial position was weak (R. 106-107). At the end of the report, the master stated that (R. 107): "The recovery allowed on the several elements of Plaintiff's 'Principal Claim' represents what has been proved to my satisfaction. As it does not represent the entire damage occasioned by Defendant's infringement and because of the 'Special Circumstances' I recommend to the Court that Plaintiff's damages be increased." In conclusion the master stated (R. 137-138):

> In accordance with the order of reference, I find that Plaintiff has sustained provable damages in the amount of $63,355.00 and is also entitled to recover profits made by Defendant in the amount of $688.89. With interest on the recoveries as reported, totalling $8,118.36, the total recovery to which Plaintiff is entitled on the facts herein reported is $72,162.25. In addition, I recommend the allowance of interest on reasonable royalty recovery and for recoveries based on lost profits from lost installation fees in the sum of $15,266.70, with any other factor or multiple of items found which to the Court should seem fitting in its discretion as provided by law to make the recovery by Plaintiff more nearly adequate to compensate him for the damage to his business under his patent.

The District Court confirmed the master's report in all essential respects and adopted the

recommendation that because of the "Special Circumstances" referred to by the master, interest should be allowed to run on the damages from a date prior to their liquidation (R. 108). In addition, the District Court adopted the recommendation that taxpayer's award be increased because United's infringement had been conscious and deliberate, stating in its unreported memorandum of decision (R. 111-112, 138):

> As has been outlined above, this court finds the defendant did not act in good faith with respect to the infringement here. The infringement was deliberate. Enough subsidiary facts appear in the master's report and are outlined in this opinion to support this ultimate finding. However, with respect to an increase in damages, I agree with Judge Brewster of this court in increasing damages where there was a deliberate infringement. That distinguished jurist, long the senior member of this court, stated in *Muther* v. *United Shoe Machinery Corp., supra,* [21 F. 2d 773,] 780: "While doubtless one of the purposes of the statute was to deter acts of infringement * * *, yet I do not conceive it to be the intent of the law to unjustly enrich the injured party at the expense of the wrongdoer." However, I believe full justice should be done to the plaintiff, the party wronged. The plaintiff has incurred considerable expense. There is little doubt that all the elements of damage done to the plaintiff are not included in the award made. On due reflection and

looking at the whole situation objectively, I believe if the award is increased fifty per cent, it will be adequate.

A judgment for the taxpayer was entered and United, taking no appeal, paid the judgment in full in April, 1944. The payment consisted of the following items (R. 108, 139):

(a) Damages for patent infringement	$63,355.00
(b) Interest on item (a)	28,020.54
(c) Increase in award	45,687.77
(d) Loss of profit on foreign sales	688.89
(e) Amount of judgment	137,752.20
(f) Interest on judgment to date of payment	609.72
(g) Total	$138,361.92

Taxpayer, in his 1944 income tax return, only included in gross income that part of the proceeds of the patent infringement, $688.89, which was awarded for loss of profit on foreign sales. The Commissioner, in determining the deficiency, allowed the taxpayer a deduction of $30,536.63 for litigation fees and expenses, and included the net amount of the recovery, $107,825.29, in taxpayer's gross income for 1944. In his explanation, the Commissioner rejected taxpayer's contention that since the award was for damages, it was not income, because it was the Commissioner's opinion that "the award appears to be entirely for profits,

royalties, and interest" and therefore constituted income for the year 1944. (R. 109.) The Tax Court approved the Commissioner's determination, holding that the entire award was for loss of income. It also held that the so-called tax benefit rule urged by the taxpayer to exclude a portion of the recovery from tax had no applicability. (R. 109-115.) The Court of Appeals affirmed. It agreed with the Tax Court that "the damages which the taxpayer sought and which the master awarded were not for loss or injury to capital but as compensation for profits or gains which the taxpayer would have enjoyed but for United's infringement." (R. 141.) It also rejected taxpayer's contention that even though the recovery was income, the "tax benefit rule" prevented imposition of the tax. (R. 141-142.)

ARGUMENT

1. The court below held, in complete harmony with the decided cases, that (R. 136) whether the net proceeds of litigation are taxable to the recipient as income or constitute a non-taxable return of capital "depends upon the object for which the suit was brought." If brought to recover "lost profits, the proceeds are taxable as income;" if brought "for loss or damage to capital, the proceeds are non-taxable." *Durkee* v. *Commissioner,* 162 F. 2d 184, 186 (C.A. 6th); *Raytheon Production Corp.* v. *Commissioner,* 144 F. 2d 110, 113 (C.A. 1st), certiorari denied, 323 U. S.

779; *Swastika Oil & Gas Co.* v. *Commissioner,* 123 F. 2d 382, 384 (C.A. 6th), certiorari denied, 317 U. S. 639; *Arcadia Refining Co.* v. *Commissioner,* 118 F. 2d 1010 (C.A. 5th); *H. Liebes & Co.* v. *Commissioner,* 90 F. 2d 932, 935 (C.A. 9th); *Farmers' & Merchants' Bank* v. *Commissioner,* 59 F. 2d 912, 913 (C.A. 6th). This principle has uniformly resulted in the holding that generally patent recoveries are ordinary income. *United States* v. *Safety Car Heating Co.,* 297 U. S. 88; *Martin Bros. Box Co.* v. *Commissioner,* 142 F. 2d 457 (C.A. 6th), affirming *per curiam* the memorandum decision of the Tax Court entered April 22, 1943 (1943 P-H T.C. Memorandum Decisions, par. 43,190); *Triplex Safety Glass Co.* v. *Latchum,* 44 F. Supp. 436 (D. Del.), affirmed *per curiam,* 131 F. 2d 1023 (C.A. 3d); *Commissioner* v. *S. A. Woods Mach. Co.,* 57 F. 2d 635 (C.A. 1st), certiorari denied, 287 U. S. 613; *First Bancredit Corp.* v. *Flexlume Corp.,* 10 F. Supp. 1015 (W.D. N.Y.); *Sly Mfg. Co.* v. *Commissioner,* 24 B.T.A. 65; *Christensen* v. *Commissioner,* 33 B.T.A. 79.

Taxpayer's objection to the decision (Pet. 5; Br. 9-12) is largely to the view of both courts below that the complaint in the patent litigation sought, and the award was made for, lost income and interest. This largely factual determination of the nature of the recovery is not only supported by the record, but a contrary view would have been erroneous as the two courts' analysis of the proceedings

in the patent litigation establishes. (R. 111-112; 140-141.) Taxpayer's assertions to the contrary (Pet. 5; Br. 11) are without support in the record and are, at best, in derogation of this Court's admonition in *Safety Car Heating Co., supra,* p. 98, that, "To determine what the respondent got we are to consider what it did, and not what it could have had if it had made another choice."

2. Taxpayer's contention (Br. 10-12) that the decision is inconsistent with *Helvering* v. *Taylor,* 293 U. S. 507, and *Durkee* v. *Commissioner,* 162 F. 2d 184 (C.A. 6th), is without merit. His belated effort to introduce evidence of the amount of damage to his capital caused by the infringement does not present the question decided by *Helvering* v. *Taylor, supra,* of the authority of a Court of Appeals to order a remand to the Tax Court where the taxpayer has established that the deficiency determined was too large, but has not, as is his burden, proved the correct amount. That question is not present here because the proffered proof pertaining to the basis of the capital allegedly destroyed by the infringement is irrelevant, as we have shown, *supra,* because the recovery sought and obtained was for lost income, not injury to capital.

3. The contention that in any event the recovery was a capital gain and not ordinary income (Pet. 5-6, 7; Br. 18-19) is also without merit. Gain from the sale or exchange of "capital assets" as defined in Section 117(a) (Appendix, *infra,* p. 13), is

treated as capital gain (Section 117(b), Appendix, *infra,* pp. 13-14), and the same treatment is accorded gain from the sale, exchange of conversion of a separately defined group of capital assets in Section 117(j) (Appendix, *infra,* p. 14). Taxpayer's contention on this point fails for the same reason as does his contention discussed, *supra.* The recovery was not obtained because of injury to capital assets. The contention is additionally deficient because there was no sale, exchange or conversion as required by the statute. Cf. *Helvering* v. *Flaccus Leather Co.,* 313 U. S. 247, 249; see also *Fairbanks* v. *United States,* 306 U. S. 436; *Burnet* v. *Harmel,* 287 U. S. 103; *Helvering* v. *Hammel,* 311 U. S. 504; *Dobson* v. *Commissioner,* 321 U. S. 231, denying rehearing of decision in 320 U. S. 489.

4. Taxpayer's contention that the decision is inconsistent with *Dobson* v. *Commissioner,* 320 U. S. 489 (Br. 13) in that the "tax benefit rule" was not held applicable (Pet. 5, 7) is both inaccurate and presents no occasion for the issuance of the writ. It was stated in *Dobson* that (p. 506), "We are not adopting any rule of tax benefits. * * *" Nor is there any occasion as taxpayer suggests (Br. 15-16) for this Court to now announce a "tax benefit rule." This has been done by Congress. Section 22(b)(12), Internal Revenue Code (Appendix, *infra,* pp. 12-13). This case does not come within that statute for various reasons, the most important of which is that the doctrine, originated by the Tax

Court, as noted by this Court in *Dobson* v. *Commissioner, supra,* and now codified, deals solely with recoveries that are income for tax purposes rather than a return of capital, only because of a previous tax deduction. That problem is not presented here because taxpayer's recovery, as we have shown, was not due to the recovery of a previous tax deduction but an award of damages for lost income.

CONCLUSION

The decision below is correct. There is no conflict of decisions or any other reason justifying the issuance of a writ of certiorari.

Respectfully submitted,

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APRIL, 1950

APPENDIX

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes * * * gains or profits and income derived from any source whatever. * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(12) [as added by Section 116 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Recovery of bad debts, prior taxes, and delinquency amounts.*—Income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount. For the purposes of this paragraph:

(A) Definition of Bad Debt.—The term "bad debt" means a debt on account of worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(B) Definition of Prior Tax.—The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

* * * * *

(D) Definition of Recovery Exclusion. The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Commissioner and with the approval of the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this chapter (not including the tax under section 102) or corresponding provisions of prior revenue laws, reduced by the amount excludible in previous taxable years with respect to such debt, tax, or amount under this paragraph.

* * * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include * * *

* * * * *

(b) [amended by Section 150(c) of the Revenue Act of 1942, *supra*] *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the

sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

* * * * *

(j) [as added by Section 151 of the Revenue Act of 1942, *supra*] *Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

* * * * *

(2) *General Rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. * * *

* * * * *

(26 U.S.C. 1946 ed., Sec. 117.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

> SEC. 29.22(b)(12)-1 [as amended by T.D. 5454, 1945 Cum. Bull. 68]. RECOVERY OF CERTAIN ITEMS PREVIOUSLY DEDUCTED.—(a) *In general.*—Section 22(b)(12) provides that income attributable to the recovery during any taxable year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in section 127, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond premiums. (See *Dobson* v. *Commissioner,* 64 S. Ct. 239.) The term "recovery exclusion" as used in these regulations means accordingly an amount equal to the portion of the bad debts, prior taxes and delinquency amounts (the items specifically referred to in section 22(b)(12), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior taxable year, did not result in a reduction of any tax of the taxpayer under Chapter 1 of the Internal Revenue Code (other than a tax under section 102) or under corresponding provisions of prior revenue laws.

* * * * *

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